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TAX FLASH NEWS

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The benefit of India-Netherlands tax treaty is not available to the Netherlands based fiscally transparent fund

The Authority of Advance Ruling (AAR) in the case of ABC, In re[1] (the applicant) dealt with the issue of eligibility of India-Netherlands tax treaty (tax treaty) benefits to the Netherlands based fiscally transparent funds. The AAR held that the income arising to funds from investment made in securities in India out of the contributions made by participants will be assessed in the hands of funds and such funds being fiscally transparent non-taxable entities in Netherlands are not eligible for the benefit of Article 13 of the tax treaty since it does not qualify to be a resident under the tax treaty. In order to qualify as a 'resident of a contracting State' one needs to qualify as a 'person' under the tax treaty. Further the AAR held that a custodian cannot be considered as a responsible entity of funds and benefit under Article 13 of the tax treaty is not admissible to the custodian also.

Facts of the case

ABC, DEF and GHI are companies incorporated in the Netherlands. ABC, DEF, GHI have invested in PQR and STU (the Funds). PQR and STU are registered with Securities and Exchange Board of India (SEBI) as a sub-account of 'The Funds Asset Management BV' (TFAM BV, Netherlands). TFAM BV is registered with SEBI as a Foreign Institutional Investor (FII) and is the fund manager responsible for the management and administration of the Fund.

PQR and STU are a 'funds for joint account' (FJA). As per the Netherlands laws, FJA does not have a separate legal status of its own. Consequently, all income and gains derived by the FJA is attributed to the investors in proportion to their participation in FJA and taxed in hands of the participant in respective proportion. JKL, Netherlands is the custodian of PQR and STU and holds the legal title to the investments made for the risk and benefits of the participants of these funds. All the income received by the Funds is distributed amongst the participants based on their participation as on the date of payment or it is transferred to the account and is held on behalf of the participant of the fund. The decision of distributing the income is jointly made by the custodian and the manager.

ABC, DEF and GHI hold share in the Funds and being participants of PQR and STU report such income in their tax return filed in the Netherlands. Such income earned by the participants is classified as capital gains and is offered to tax by them at the rate of 25 per cent in Netherlands.

In this background, an application was filed before the AAR for the eligibility of tax treaty benefits in the hands of funds.

AAR ruling

Eligibility of tax treaty benefits

A perusal of the tax-treaty indicates that the tax treaty provisions shall apply to 'persons' who are residents of one or both the countries. The term 'person' is defined under Article 3(1)(e) of the tax treaty to include an individual, a company, any other body of persons and any other entity which is treated as a taxable unit, under the taxation laws in force in the respective States. As per Article 4 of the tax treaty, the term 'resident of one of the States' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. In the present case, FJA funds are not taxable units under the Netherlands tax laws. Thus, the funds being not taxable entities are neither persons nor residents of Netherlands in terms of the tax treaty. The funds are also not resident of India therefore, tax treaty benefits are not admissible to these funds.

[1] ABC, In re [2021] 125 taxmann.com 293 (AAR)

It is a fact that the participants who are tax residents of Netherlands, have not directly invested in India but the investment has come through two funds. These funds are registered entities with SEBI and income accrues to them on their own. Whether the said income is passed on to the participants in its entirety is a separate issue and stage 2 of transaction and has nothing to do with accrual of income in India. On one hand there are participants who have not directly invested in India and on the other hand there are funds who are not legal and taxable entities of Netherlands. The treaty benefits are admissible if the stipulations contained in the convention are fulfilled by the entities.

The applicant contended that tax department should go beyond the treaty provisions and see the real nature of the transactions and allow the treaty benefits. However, the AAR held that if the tax treaty intends offering benefits to an entity, it would provide for it, in its provisions specifically and they cannot travel beyond the tax treaty provisions and draw unintended conclusions. Such a view is apparent from several enabling provisions in tax treaties with some other countries.

Custodian and legal ownership

A plain reading of the Section 160(1) suggests that at best custodian can be representative assessee under Section 160(1)(i) or (iv) but the custodian is a resident of Netherlands and certainly not an agent of the participants or the funds. Further, the custodian is not a trust under Indian Trust Act, 1882 and therefore does not fall under Section 160(1)(iv). The AAR observed that no income has accrued to the custodian and thus there was no issue of taxing it in like manner and to like extent as participants. In any case JKL is not a trust as per Netherlands laws or under Indian Trust Act. It is a private limited company incorporated under the laws of Netherlands. It may resemble a trust, but it is not a trust. Therefore, in the present case the participants are sole beneficiaries of the so-called trust and are also the settler. So, it does not satisfy the essential ingredients of the trust.

Revocable transfer of assets

The applicants further contended that under Master Funds Management and Custody conditions, the participants have made a revocable transfer of assets in favour of the funds and thus the income arising therefrom shall be included in the hands of the participants and the participants being tax resident of Netherland, the tax treaty benefit should be granted. The AAR observed that it was at best an alternate contention, however, in it was already held that the treaty benefit is not admissible to the funds or participants or the custodian. Therefore, no further determination is required.

These are essentially clubbing provisions enacted to counter the design by the applicant to reduce its tax liability by parting its property in such a way that the income should no longer be received by him but at the same time he retains certain powers over property/income. In the present case there was no such design apparent from master custody arrangement to transfer income of participant to some other person. Hence, the reference to these sections is not pertinent.

The AAR referred to various decisions[2] and observed that for claiming treaty benefits, the entity has to satisfy the definition of person and resident under the treaty articles. In the case of Linklaters LLP, the UK LLP was held to be a person in terms of tax treaty. However, in the present case the AAR is not dealing with the case of partnership firm but an entity which is not even a person as per Article 3(1)(e) of the treaty. Further, the Tribunal based its decision on concept of economic double taxation. The AAR is not persuaded by the reasoning of the decision of the Mumbai Tribunal in the case of Linklaters LLP[3]. The decision has gone beyond the treaty provisions and suggested a new approach to interpret the treaty provisions. However, AAR in the present case observed that it has to interpret treaty provisions in its plain and simple terms. In case there is ambiguity, recourse can be taken to commentaries and other literature on the topic. When there is no ambiguity in regard to any provision of the tax treaty, one cannot add some interpretation to arrive at unintended conclusions. For the same reasons, the AAR is also not agreeable to the decision of the Mumbai Tribunal in the case of NNIP Bewaar Maatschappij I BV[4].

Reliance on international commentaries and material

The AAR made reference to the decision of the Supreme Court in the case of P. V.A. L. Kulandagan Chettiar[5] and observed that if the tax treaty provides specific provisions which are unambiguous, no reference may be made to the international materials and Commentaries. The approach of the Indian judiciary is to interpret the law as per the letter and spirit of the law. On the other hand, Indian judicial forums at various instances have acknowledged the importance of international commentaries in interpreting the provisions of tax treaties. The Supreme Court in the case of Azadi Bachao Andolan[6] observed that the Commentaries of these Model Tax Conventions can be relied on when it comes to construing similar terms occurring in the Act.

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[2] Linklaters LLP [2010] 40 SOT 51 (Mum), General Electric Pension v. Unknown A.A.R. (No. 659 of 2005), Schellenberg Wittmer 24 taxmann.com 299 (AAR)
[3] Linklaters LLP [2010] 40 SOT 51 (Mum)
[4] NNIP Bewaar Maatschappij I BV v. DCIT (ITA No. 7119/MUM/2014)
[5] CIT v. P. V.A. L. Kulandagan Chettiar [2004] 137 Taxman 460 (SC)
[6] Union of India v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

Reading the two judgments of the Supreme Court harmoniously, it can be suggested that the Indian courts while interpreting treaties go by the explicit language of the tax treaties as a general rule first and then in case of any ambiguity, reference may be made to other materials and the Model Conventions. In a decision of the Canadian Supreme Court In R. v. Crown Forest Industries Ltd.[7] where it was pointed out that the paramount rule in interpretation of a treaty is to look to the language use and the intention of the parties on plain reading of the provision consistent with goals and purposes of the agreement. External aids can be taken only where there is ambiguity in the language. Where there is such ambiguity, model conventions and the commentaries as well as the working papers should be considered. OECD commentaries have received recognition only as such extrinsic material.

No treaty benefits to a fiscally transparent entity

From a conjoint reading of OECD commentary outlining India's position on Article 1 it is clear that stand of India is that if a partnership is denied the benefits of a tax convention its members are entitled to the benefits of the tax conventions entered into by their State of residence provided the enabling provisions are included in the convention and as a corollary in their absence the treaty benefit cannot be extended to the partnership. This view also finds support from various subsequent mutual agreements between Netherland and US, Norway, UK, Denmark, Sweden, Canada, Germany and Indonesia which provide for the treaty benefit to tax transparent closed FJA.

Article 1, 3 and 4 read together clearly point that treaty benefit is not available to fiscally transparent entity as it is not a taxable entity in Netherlands. In order to qualify as 'resident of a contracting State' one needs to qualify as 'person' as per the definition given in the tax treaty. Here the funds are neither persons nor residents of Netherlands. Secondly India has not concurred with the view in OECD commentary and has elucidated by stating that there is need for enabling provision in treaty to allow the treaty benefit to beneficiaries of transparent entities. The India-US tax treaty (Article 4) provides for benefit for firms or trusts if partners or beneficial owners are taxed on same income but similar enabling provision is missing under the India-Netherlands tax treaty. In the alternative India can enter into competent authority agreement with Netherland to allow treaty benefit to transparent entity. This is in line with similar arrangements Netherland have with some other countries.

[7] R. v. Crown Forest Industries Ltd. [1995] DTC 5389

Accordingly, it has been held that income arising to PQR and STU from investment made in securities in India out of the contributions made by ABC, DEF or GHI will be assessed in the hands of PQR and STU and the benefit under Article 13 of the tax treaty is not admissible to these funds. The AAR also held that JKL cannot be considered as a responsible entity of PQR and STU funds and the benefit under Article 13 of the tax treaty is not admissible to JKL.

Taxable under the Income-tax Act

Being a sub-account of FII and registered as such with SEBI, the income from investments in India has accrued to both these funds (i.e. PQR and STU) in India and is taxable under Section 5 read with Section 9(1)(i) of the Income-tax Act, 1961 (the Act).

Our comments

The AAR dealt with the eligibility of India-Netherlands tax treaty benefits to the Netherlands based fiscally transparent funds and held that the income arising to such funds from investment made in securities in India out of the contributions made by participants will be assessed in the hands of funds and such funds being fiscally transparent non-taxable entities in Netherlands are not eligible for the benefit of Article 13 of the tax treaty. Further the custodian has not been considered as a responsible entity of funds and therefore the benefit under Article 13 of the tax treaty is not admissible to the custodian also.

The Mumbai Tribunal, in the case of Linklaters LLP, treated that UK partnership firm as a transparent entity eligible for the India-UK tax treaty benefit since the income was taxable in the hands of members of the partnership firm. However, the AAR observed that the present case was not dealing with the case of partnership firm but an entity which is not even a 'person' as per Article 3(1)(e) of the India-Netherlands tax treaty. Further, the AAR observed that the Mumbai Tribunal has gone beyond the treaty provisions and suggested a new approach to interpret the treaty provisions.

The applicant while referring to the OECD Commentary contended that if a partnership is denied the benefits of a tax convention, its members are entitled to the benefits of the tax conventions entered into by their state of residence subject to conditions being fulfilled. However, the AAR did not rely on OECD Commentary and observed that external aids can be taken only where there is ambiguity in the language. However, it is pertinent to refer to the latest Supreme court decision in the case of Engineering Analysys Centre of Excellence Private Limited[8] where the Supreme Court observed that OECD commentary will continue to have persuasive value as to the interpretation of tax treaties.

Though the ruling deals with the taxability of capital gains, it could be relevant for the taxability of dividends paid by the Indian companies. From 1 April 2020, Indian companies are liable to deduct taxes at the rate of 20 per cent (under the Act) on payment of dividend to non-resident shareholders subject to beneficial tax rate under the relevant tax treaty. It would be interesting to see the impact of this decision on the taxability of dividend payment by the Indian company to such funds especially under the India-Netherlands tax treaty.

[8] Engineering Analysys Centre of Excellence Private Limited v. CIT (Civil Appeal Nos. 8733-8734 of 2018)

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